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INVESTMENT OUTLOOK 08.2020

8 August 2020

Politicians and market participants seem to be caught up in a sugar-rush-like euphoria. While politicians issue huge amounts of debt — cost-free as interest rates are zero or even negative — the investors are enjoying a market rally of almost all asset classes, detached from fundamental pricing models.

The sugar-providers are the central banks, which have forced real and even nominal interest rates into negative territory and have provided ample liquidity via various quantitative easing programs. Fig. 35 on page 10 shows how central-bank balance sheets have inflated since 2008, with massive additional increases in 2020. Central banks have become less and less picky when it comes to the type of assets they buy. Purchases increasingly include government debt, high-yield bonds, and equity.

The recent gold rally, which coincides with the collapse of real interest rates, illustrates how inflated asset prices have become.

We are retaining our cautious stance and we see risks for markets clearly skewed to the downside.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

THE GOLD MARKET RALLY

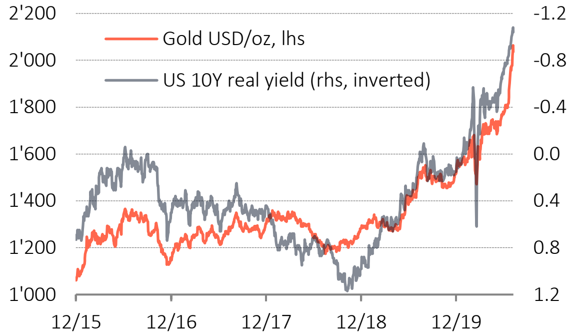
Financial markets

In July US equities outperformed European equities. While the S&P500 index rose by 5.5%, the MSCI Europe fell 1.5%. The MSCI Emerging Markets index rose 8.4%, fueled especially by a strong Chinese CSI300 index, which climbed 12.8%. The Chinese equity market rose 15% year-to-date. Meanwhile equity valuations appear to be stretched, especially since the earnings outlook has deteriorated. Sector performances have been remarkably diverse. While technology and consumer staples performed very strongly, energy, finance and real-estate stocks clearly fell.

In July government-bond yields fell again, driven by continued central-bank bond buying. Real rates, however, declined even more, which is tantamount to rising inflation expectations. For example, US 10-year real rates fell below -1%, a historic low. The ultra-low real interest rates help to explain the rally of almost all asset classes. Real interest rates reflect what investors can expect after accounting for inflation. Real yields further represent investors' expectations of real economic growth. However, we have to assume that excessive central-bank policy measures have distorted the messages to be drawn from fixed income markets.

Gold rallied strongly in July, breaking clearly above USD 2,000 per ounce. There is a remarkably strong correlation between real interest rates and the price of gold. We see this as a sign that people are getting worried about the general health of the financial system. The price for Brent oil stabilized above USD 40 per barrel, as demand picked up somewhat and oil producers remained disciplined. Industrial metals surged, propelled by the recovery in China, which is the major driver for demand. The market for REITS remains weak due to uncertainties about how COVID will impact the real-estate market.

Price of gold highly correlated with real interest rates



The major theme for currency markets at present is the weakness of the USD, which fell about 10% against the EUR from mid-March and weakened vs many other major currencies. This can be explained by extremely aggressive Fed easing, which narrowed interest-rate differentials significantly. Many emerging market currencies, like the BRL and the MXN, rebounded in July after massive depreciations earlier this year

Covid-19

There are no real signs of relief. The global total of cases is just shy of 20 million, while the daily number of new cases seems to be stabilizing at about 285,000. The global death toll stands at 725,000, of which 164,000 deaths were recorded in the US. In Europe, where lockdown measures have been very effective, the number of cases is beginning to rise again, albeit at a moderate pace. Meanwhile, new fiscal support measures were announced, but this could not stop the US bankruptcy index from rising further in July.

Macroeconomics

Many growth indicators rebounded after the trough in April. For example, the US ISM index rose to 54.2 after 52.6. This reflects a certain uptick in economic activities after lockdown measures were eased. However, the recent PMI numbers obscure the fact that the global economy is in the midst of an unprecedented slump with long-lasting effects. In its recent "World Economic Outlook" the IMF projects that in 2020 GDP will fall by 5.9% in the US, 7.5% in the Euro Area, and by 1% in emerging and developing economies.

Since the US labor market is very flexible, job destruction and job creation can be seen almost in real time. In July employers added 1.8 m jobs, considerably less than in June when 4.8 m jobs were created. This may be explained by new virus outbreaks in the south and west of the US. The US unemployment rate fell to 10.2% in July from 11.1% in June.

Geopolitics

President Donald Trump imposed sanctions on various Chinese and Honk Kong politicians, among them Hong Kong Chief Executive Carrie Lam. In addition, the US administration banned US companies from dealing with WeChat, a messaging app, and TikTok, an immensely popular video app. Microsoft is in talks with a view to buying TikTok. This is another drastic attempt on the part of the US to address alleged Chinese economic espionage and civil-rights abuses. This came only weeks after the US closed China's Houston consulate, and China responded by closing a US consulate in Chengdu.

The US-China relationship clearly reached its worst state since diplomatic relations were entered into on 1 January 1979.

Monetary policy

On 29 July the FOMC concluded its two-day meeting and made no major changes to its current monetary policy. The US Fed continues to keep interest rates close to zero and announced that it would be ready to implement additional stimulus measures to support the recovery, if needed. Chairman Jerome Powell expressed his concern about the COVID-19 outbreak and the crucial effect that the virus will have on the future growth path.

During March, when financial markets panicked, a shortage of USD led to disruptions in the interbank market. The US Fed reacted by introducing emergency swap lines to provide sufficient liquidity. Aware of possible future market disruptions, the US Fed extended emergency swap lines with some central banks until the end of the first quarter of 2021.

On 16 July the ECB kept interest rates unchanged and announced that it would continue to deploy its Pandemic Emergency Purchase Program (PEPP) of EUR 1.35 tn.

At the end of July the ECB called on banks to freeze dividend payments until at least January 2021 and to be extremely moderate with staff bonus payments during the pandemic. This constitutes an attempt to strengthen bank balance sheets to absorb potential losses and maintain the banks' ability to lend. This aroused criticism especially among banks' shareholders, while most banks' stocks sold-off after the announcement. UK and Swiss regulators followed with similar statements.

On 4 August the Bank of England voted to keep the bank rate at 0.1% and its target for the total stock of asset purchases steady at GBP 745 bn.

Meanwhile the People's Bank of China (PBoC) announced that it is not planning further stimulus measures as its economy would recover. The PBoC took decisive measures earlier this year by lowering the reserve requirement ratio (RRR), cutting rates for its medium-term lending facility (MLF), and initiating large loan programs.

Outlook

We believe that markets are failing to price existing downside risks accurately, and therefore we remain cautiously positioned. The pandemic is far from over. Rising European Covid-19 cases suggest that more prolonged and tighter lockdown measures might be necessary to prevent the virus from spreading in an uncontrolled fashion. Furthermore, it is very likely that the virus will spread more violently again when the northern-hemisphere winter approaches

In addition, we are keeping an eye on the rising geopolitical tensions, especially between the US and China.

Despite the above-mentioned risks, government support measures are unprecedented and continue to bolster the markets. While we expect that sooner or later it will become quieter regarding new support measures, we initially expect additional fiscal support in the coming months. Most notably, the US Congress may decide on another USD 2.5 tn fiscal program, introducing additional and more generous unemployment benefits.

ECONOMICS

Many growth indicators rebounded after the trough in April. This reflects a certain uptick in economic activities after lockdown measures were eased. However, the recent PMI numbers obscure the fact that the global economy is in the midst of an unprecedented slump with long-lasting effects. Since the US labor market is very flexible, job destruction and job creation can be seen almost in real time. In July employers added 1.8 m jobs, considerably less than in June when 4.8 m jobs were created. This may be explained by new virus outbreaks in the south and west of the US.

Fig. 1: PMIs

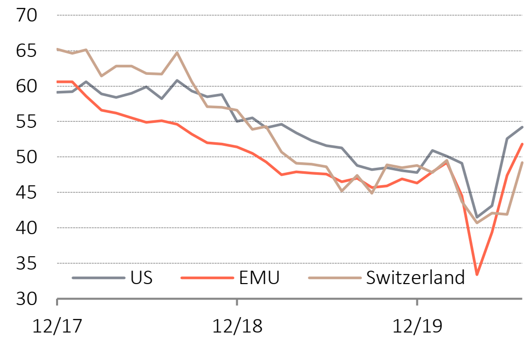


Fig. 2: PMIs

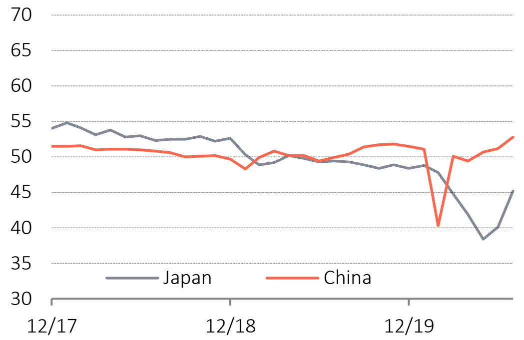


Fig 3: Consumer price inflation, in % YoY

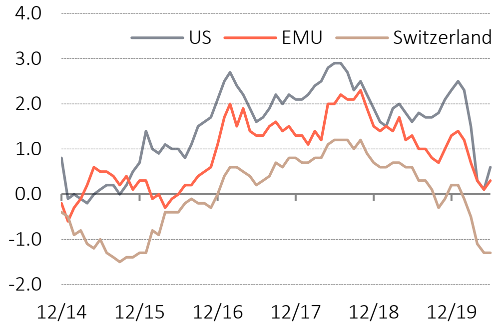


Fig. 4: Consumer price inflation, in % YoY

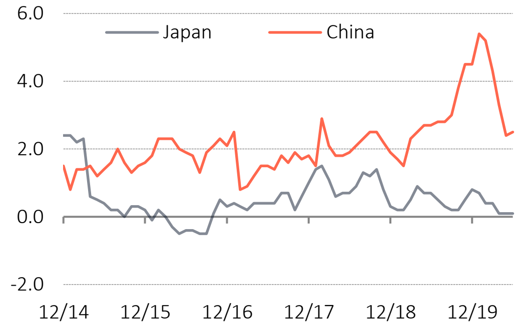


Fig 5: Unemployment rates, in %

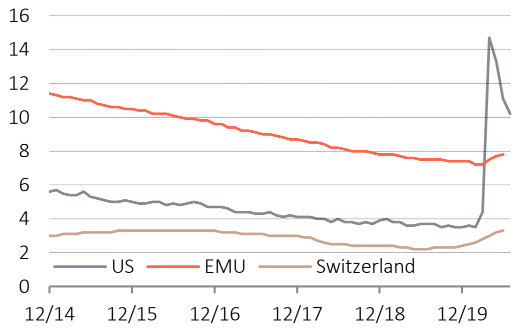
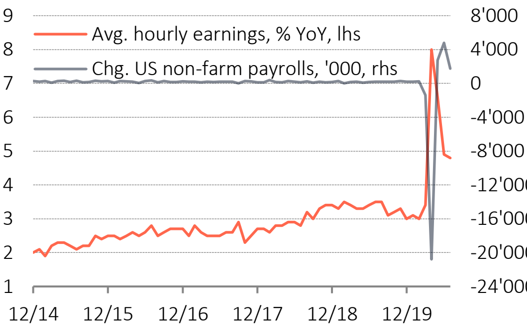


Fig 6: US labor market



FIXED INCOME

In July government-bond yields fell again, driven by continued central-bank bond buying. Real rates, however, declined even more, which is tantamount to rising inflation expectations. For example, US 10-year real rates fell below -1%, a historic low. Real interest rates reflect what investors can expect after accounting for inflation. Real yields further represent investors' expectations of real economic growth. However, we have to assume that excessive central bank policy measures have distorted the messages to be drawn from fixed-income markets.

Fig.7: 2Y government bond yields

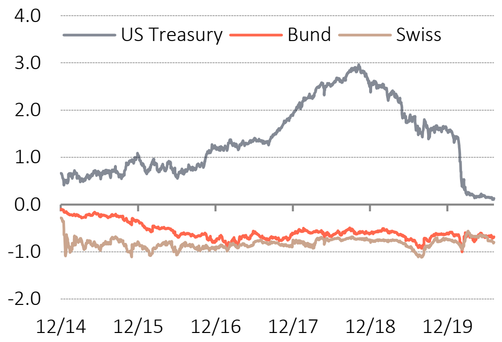


Fig. 8: 10Y government bond yields

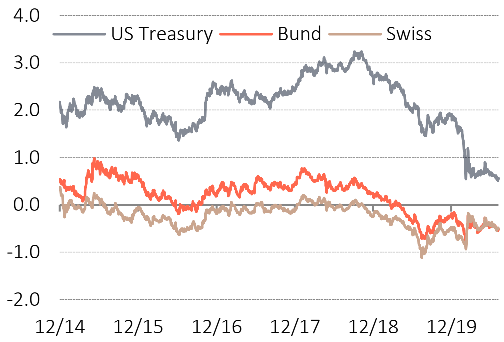


Fig 9: 10Y break-even inflation

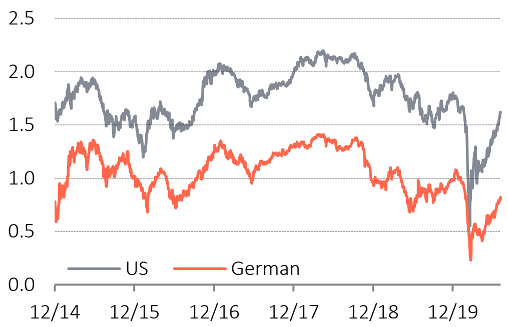


Fig. 10: Credit spreads, 5Y credit default swaps

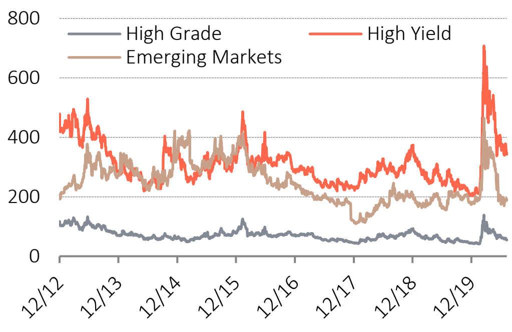


Fig 11: Money market spreads (3M-2Y)

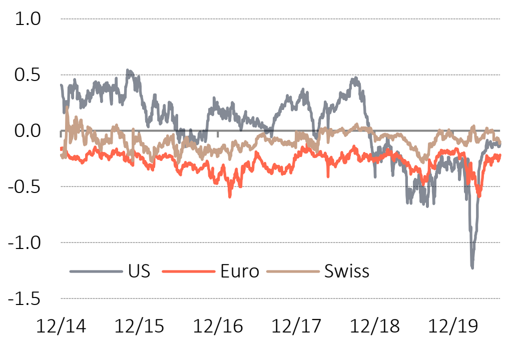
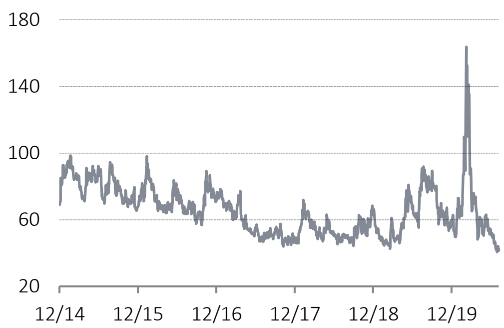


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

In July US equities outperformed European equities. While the S&P500 index rose by 5.5%, the MSCI Europe fell 1.5%. The MSCI Emerging Markets index rose 8.4%, fueled especially by a strong Chinese CSI300 index, which climbed 12.8%. The Chinese equity market rose 15% year-to-date. Meanwhile equity valuations appear to be stretched, especially since the earnings outlook has deteriorated. Sector performances have been remarkably diverse. While technology and consumer staples performed very strongly, energy, finance and real-estate stocks clearly fell.

Fig. 13: MSCI equity indices – major regions

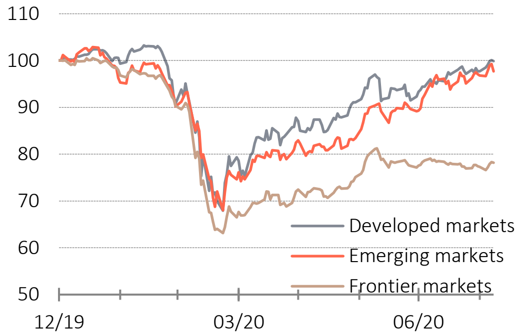


Fig.14: Equity indices – major developed markets

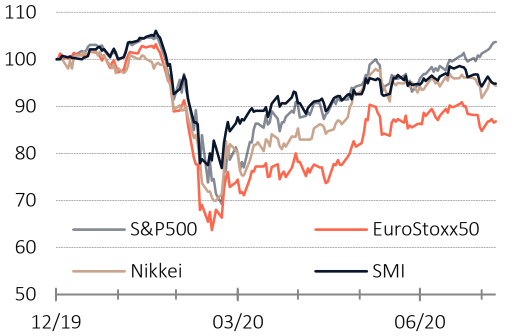


Fig 15: Equity indices – major emerging markets

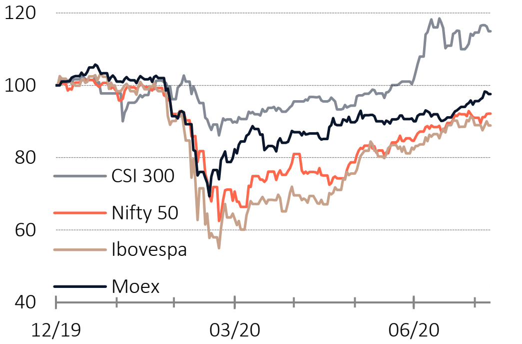


Fig. 16: Sector performance, MSCI Europe, YTD

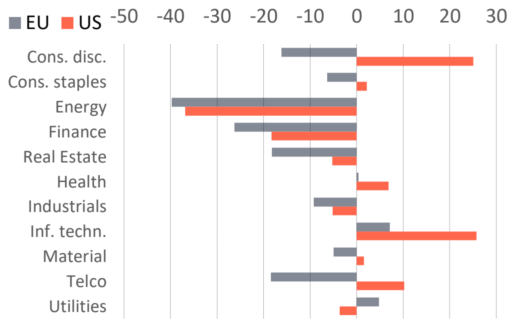


Fig 17: Price-earnings ratios

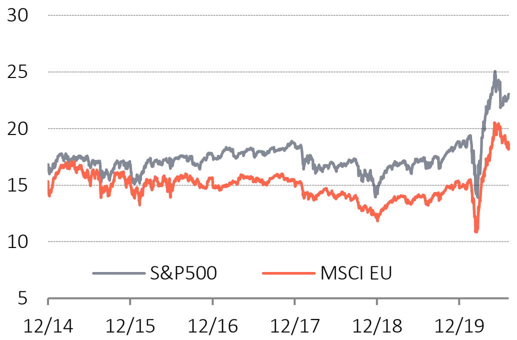
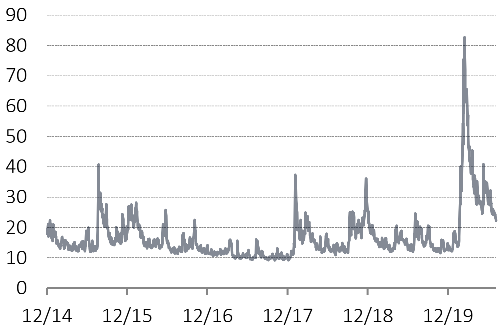


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Gold rallied strongly in July, breaking clearly above USD 2,000 per ounce. We see this as a sign that people are getting worried about the general health of the financial system. The price for Brent oil stabilized above USD 40 per barrel, as demand picked up somewhat and oil producers remained disciplined. Industrial metals surged, propelled by the recovery in China, which is a major driver for demand. The market for REITS remains weak due to uncertainties about how COVID will impact the real-estate market.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

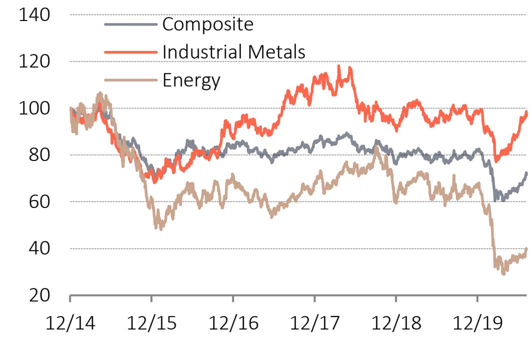


Fig. 22: HFRU hedge fund indices

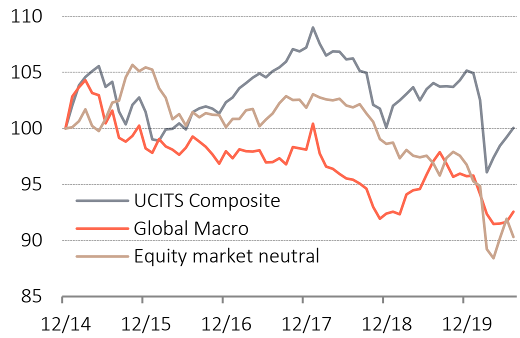


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

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Fig. 25: EUR-USD exchange rate

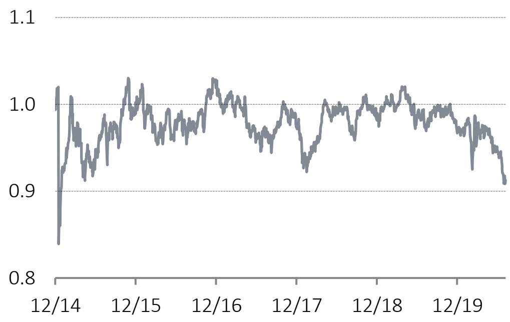
Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

Fig 30: USD-CHF exchange rate



COVID-19

There are no real signs of relief. The global total of cases is just shy of 20 million, while the number of daily new cases seems to be stabilizing at about 285,000. The global death toll stands at 725,000, of which 164,000 deaths were recorded in the US. In Europe, where lockdown measures have been very effective, the number of cases is beginning to rise again, albeit at a moderate pace. Meanwhile, new fiscal support measures were announced, but this could not stop the US bankruptcy index from rising further in July.

Fig. 31: Total Covid-19 cases (x 1000)

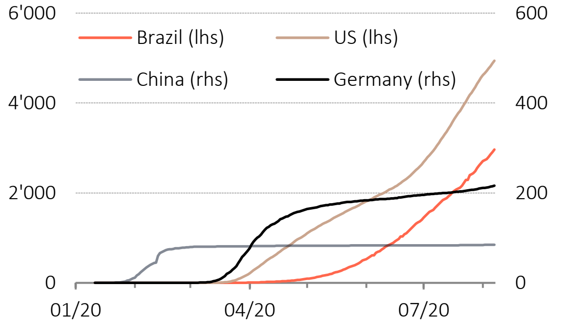


Fig. 32: New cases per day (7-day average)

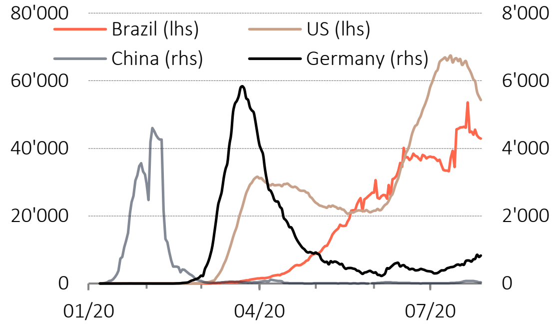


Fig 33: US bankruptcy index

Fig.34: US personal income, excl. transfers (USD bn, 2012 prices)

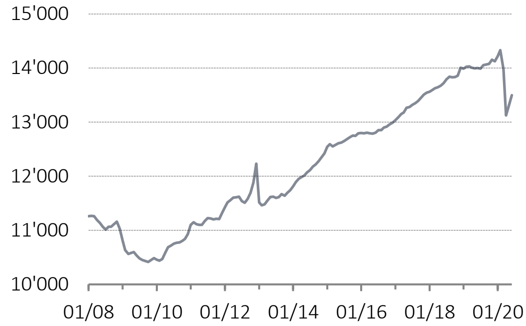


Fig 35: Central bank total assets, indexed

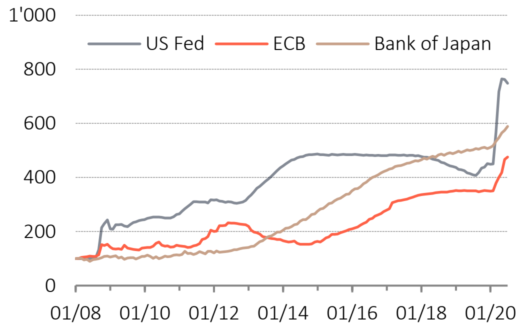
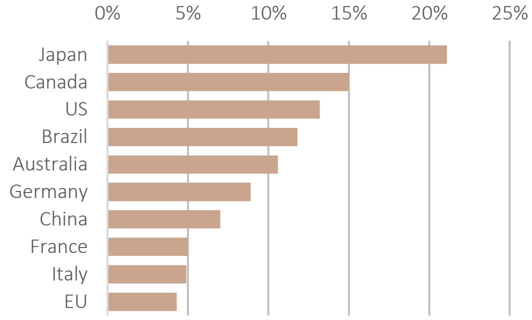


Fig 36: COVID-19 fiscal stimulus as of June 2020, % of GDP (Source: Statista)



ASSET ALLOCATION

The rally of gold stands out. Gold rose by 30% year-to-date. Inflation-linked and corporate bonds also performed very strongly this year but lag behind gold by a wide margin. In July, most risky assets drove the performance of a multi-asset class portfolio, especially US and emerging markets equities.

A EUR-based portfolio faced headwinds, though, since in July most foreign currencies fell, especially the USD.

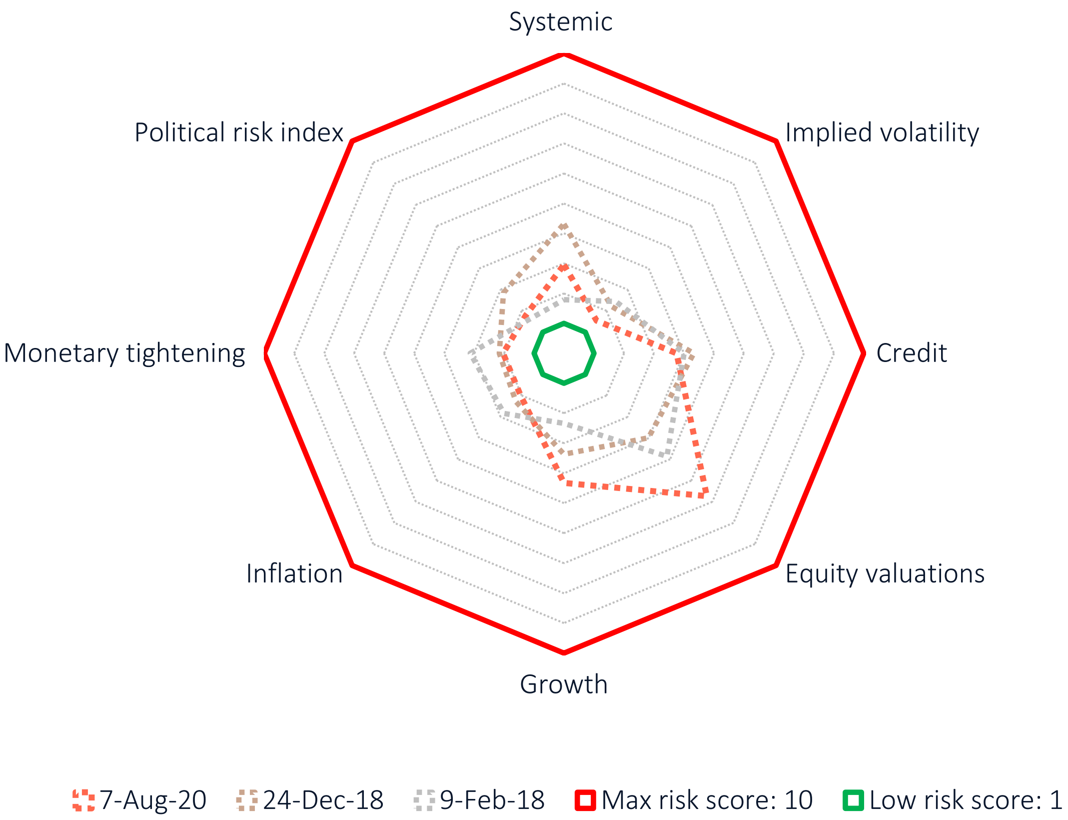
Fig. 37: Performance of major asset classes, based on our EUR portfolio strategy

RISK MONITOR

Our risk monitor highlights elevated equity valuations as the major risk. Growth risks have subsided, and our risk indicators (purchasing manager indices, PMIs) reflect the recovery from the deep slump in March and April, but obscure the fact that overall economic activity has dropped significantly since last year. Implied volatility, insurance premiums to protect against falling markets, fell significantly. This could also be interpreted as market participants becoming increasingly complacent.

Fig. 38: IMT Risk Monitor

24 Dec 2018: Growth and monetary tightening fears
09 Feb 2018: Inflation fear and technical correction



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Source for all graphs: Bloomberg, IMT Asset Management AG, for Fig 36 Statista (de.statista.com), for Fig. 38, the political risk index: “Measuring Geopolitical Risk” by Dario Caldara and Matteo Iacoviello at https://matteoiacoviello.com/gpr.htm.